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Another Rise In The Yen?

After peaking at a postwar record high of Y137.25=$1.00 on April 27, the yen has since retreated to the Y150 level. Market analysts attribute the dollar's renewed strength to a surge in Japanese purchases of U.S. securities and to tensions in the Persian Gulf. In addition, the dollar has gotten a boost from favorable U.S. economic statistics, including the decline in the unemployment rate to 6 percent in July.

The recent stability of the yen is one of the factors pointing to an economic recovery in Japan. Last week the Wako Research Institute of Economics, which in June predicted a 7 percent rise in the pretax profits of 319 major Japanese manufacturing companies in FY 1987, revised its figure upward to 22.4 percent. The institute expects the fall in the yen since mid-May to boost the earnings of export-oriented firms. Other positive factors include brisk domestic demand for cars and consumer electronics products.

Exchange rate stability also encouraged Japanese purchases of U.S. Treasury bonds in the quarterly refinancing operation August 11-13. Some

analysts expected that the large foreign exchange losses recorded by Japanese investors -- $10.2 billion for life insurance firms alone in FY 1986 -- would limit purchases this time around. Last week, though, Japanese investors accounted for 35 to 40 percent of the $9 billion in 30-year bonds auctioned.

The 3.8 percent dip in the yen from June to July has contributed to concerns about rising inflation. The wholesale price index rose 0.9 percent in July over the previous month, the largest increase since April 1980. Officials of the central bank attributed the rise to higher import prices due to the yen's decline and rising crude oil prices. Another factor was the increase in prices of building materials, reflecting the boom in housing construction. The concern, however, has probably been exaggerated; wholesale prices in July were 2.2 percent below a year ago and Nomura Research Institute predicts a modest 0.6 percent rise in consumer prices in the current fiscal year. Still, this marks a turnaround from the 0.5 percent decline recorded in the last half of FY 1986.

Major Japanese financial institutions expect the yen to remain in the 140-150 range during FY 1987 (see Table). The continued large U.S. trade deficit, though, remains a destabilizing factor in the market. The announcement that the June deficit was an unexpectedly large $15.7 billion caused a sharp 2.5 percent drop in the dollar in the following two trading days. Moreover, other analysts question the commitment of the new Federal Reserve Board chairman, Alan Greenspan, to defend the dollar. Shortly before his nomination June 2, Mr. Greenspan said the dollar will fall further as overseas demand for dollar investments declines.

Economic Forecasts for Japan in FY 1987

(percentage change in real terms)

	GNP	Private Capital Spending	Current Account Surplus*	Y/$ Exchange Rate
Mitsubishi Research Institute	2.3%	2.5%	$85.4	Y140.0
Tokai Bank, Ltd.	2.8	4.8	80.0	145.0
Fuji Bank, Ltd.	2.8	2.9	86.0	148.0
Sumitomo Bank, Ltd.	2.9	4.5	87.6	145.8
Sanwa Research Institute	3.4	4.7	89.5	145.0

*In billions of dollars.

The Bank of Japan's monetary policy is a key variable in the exchange rate outlook. A decision by the central bank to tighten credit in response to concern over inflation has boosted Japanese interest rates during the past few months and lowered the U.S.-Japan interest rate gap from 6 percentage points in May to about 4 percentage points. A further rise in Japanese rates, though, would threaten Japan's economic recovery, in addition to putting upward pressure on the yen. Bank of Japan governor Satoshi Sumita promised July 29 to continue expansionary monetary policies, suggesting that the exchange rate is

likely to remain in its current zone in the near future. In the long term, however, Japan's higher rate of productivity growth and lower rate of inflation will cause the dollar to decline relative to the yen.

Randall S. Jones

Capital Adequacy Ratios Debated

As boundaries between national financial markets blur, Washington, London and Tokyo are directing attention to the methods used to evaluate the health of financial institutions. Discussions at the Bank for International Settlements have focused on how to calculate the ratio of capital to assets, referred to as the capital adequacy ratio or simply CAR (see JEI Report No. 11B, March 20, 1987).

CAR is important because it is a measure of how well a bank can absorb business losses without becoming endangered. Shareholders' equity plus any loan loss reserves are compared to total assets. For U.S. and European banks, the ratio averages about 5 percent; using the same accounting techniques, Japanese banks average just under 3 percent. Since internationally 12 of the top 20 banks ranked by assets are Japanese (the result in large part of the yen's sharp appreciation), there is some concern that Japanese banks are not as sound as they should be. In addition, foreign competitors charge that the lower CAR of Japanese banks gives them an unfair advantage in other markets.

In February the United States and Great Britain narrowed the ways of defining CAR to reflect the common features of their financial markets. Tokyo was caught off-guard and has been trying to build support for some provisions based on Japanese financial realities. The central issue is how to treat so-called "hidden reserves" or appreciated assets carried at book value. These can be quite significant because Japanese banks have held Japanese blue chip stocks and bonds for several decades. The recent run-up in the Tokyo Stock Exchange has further widened the gap between book and market values.

Ministry of Finance officials argue that these reserves should be included in CAR calculations. At first they proposed using the full market value but the latest proposal would allow banks to add 70 percent of the estimated value of hidden reserves to shareholders' equity. Such a move would have a major impact -- raising CARs to between 8 and 16 percent (see Table). Washington and London object to this approach, however, because of the extreme volatility of the Tokyo market, and have suggested dropping the level to 30 percent. MOF has said that it took this factor into account when it decided on the 70 percent figure.

MOF is moving in other ways to allay foreign concerns. It has already directed financial institutions to raise their CARs to at least 4 percent by the end of fiscal 1990. Observers estimate that this translates into an additional Y8 trillion ($53.3 billion at Y150=$1.00) in equity. To manage this in only four years, several major banks have already announced new stock or bond issues, and others will surely follow. Although some have attributed the tough Anglo-American stance to the increasing problems of third world debt (Japanese banks have the second-greatest exposure behind the Americans), others see it as an attempt to blunt the aggressive tactics of the Japanese banking industry.

Even if they are saddled by huge new fund-raising burdens, Japanese banks will continue to play an increasingly important role in global finance.

Jon Choy

Japanese Banks' Capital Ratios, March 31, 1987

(in percent)

Bank	Capital-to-Assets Ratio*	Including 70 Percent of Hidden Reserves**
Mitsubishi Bank, Ltd.	3.22%	11.93%
Mitsui Bank, Ltd.	2.97	10.94
Daiwa Bank, Ltd.	3.59	10.82
Kyowa Bank, Ltd.	3.81	10.61
Fuji Bank, Ltd.	3.31	9.70
Tokai Bank, Ltd.	2.92	9.70
Dai-Ichi Kangyo Bank, Ltd.	2.87	9.66
Sanwa Bank, Ltd.	3.02	9.36
Bank of Tokyo, Ltd.	3.53	9.19
Sumitomo Bank, Ltd.	3.11	9.09
Taiyo Kobe Bank, Ltd.	2.77	9.00
Saitama Bank, Ltd.	3.09	8.84
Mitsui Trust & Banking Co., Ltd.	3.44	16.28
Mistubishi Trust & Banking Corp.	3.81	15.94
Yasuda Trust & Banking Co., Ltd.	3.20	14.67
Sumitomo Trust & Banking Co., Ltd.	3.74	13.48

*Capital and reserves (not including acceptances and low-risk bank guarantees) as stated in public accounts less bad loan reserves.
**Hidden reserves are unrealized gains on assets not included in public accounts.

Source: Nihon Keizai Shimbun

Political Outlook

As the Diet's extraordinary session winds down, Japanese politicians are gearing up for the final jockeying to select the head of the Liberal Democratic Party. At this writing, it appears that Noboru Takeshita will be the victor in the race for party president and prime minister.

Four figures have emerged thus far: LDP executive director Takeshita; party executive council chairman Shintaro Abe; Finance Minister Kiichi Miyazawa; and former party vice president Susumu Nikaido. Political pundits largely share the belief that under the guidance of Deputy Prime Minister Shin Kanemaru, Mr. Abe has agreed to side with Mr. Takeshita in return for the latter's support for the party presidency once his term ends. Mr. Kanemaru has been a key figure in party matters in recent years and played a critical role

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1985	1986	January-June 1986	January-June 1987	April 1987	May 1987	June 1987
Japan's Balance of Payments							
Trade Balance	$55,986	$92,827	$38,474	$48,196*	$8,790*	$8,050*	$7,983*
Exports (f.o.b.)	174,015	205,591	97,083	106,337*	19,234*	18,155*	18,433*
Imports (f.o.b.)	118,029	112,764	58,609	58,141*	10,444*	10,105*	10,450*
Current Account Balance	49,169	85,845	35,767	43,532*	7,985*	7,088*	7,497*
Long-Term Capital (net)	-64,542	-131,461	-47,872	-76,442*	-12,575*	-12,661*	-18,997*
Overall Balance	-12,318	-44,767	-10,322	-19,329	-1,794	-1,451	-11,212
International Reserves (end of period)	26,510	42,239	33,905	69,273	68,620	68,935	69,273
Japan's Customs Clearance Trade							
Trade Balance	46,099	82,743	34,236	53,562*	7,552	6,429	6,609*
Exports (f.o.b.)	175,638	209,151	98,665	121,836*	19,505	18,621	18,799*
Cars	25,402	32,945	15,912	17,025*	3,599	3,107	2,843*
Steel	13,566	12,706	6,154	5,864*	1,049	960	1,018*
Imports (c.i.f.)	129,539	126,408	64,429	68,275*	11,953	12,192	12,191*
Crude Oil	34,599	19,481	12,388	10,057*	1,840	1,423	1,456*
Japan-U.S. Trade							
Trade Balance	39,485	51,401	23,034	24,642*	5,137	4,449	4,014*
Exports (f.o.b.)	65,278	80,456	37,617	39,186*	7,432	6,957	6,794*
Imports (c.i.f.)	25,793	29,054	14,583	14,543*	2,295	2,508	2,780*
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-49,749	-58,575	-28,702	-29,738	-4,946	-5,074	-5,345
Exports (f.a.s.)	22,631	26,882	13,072	12,574	2,171	2,152	2,293
Imports (c.i.f.)	72,380	85,457	41,774	42,312	7,117	7,225	7,638
Trade Balance (f.a.s./Customs)	-46,152	-55,030	-26,888	-28,054	-4,662	-4,782	-5,040
Exports (f.a.s.)	22,631	26,882	13,072	12,574	2,171	2,152	2,293
Industrial Supplies	8,680	8,752	4,122	4,630	768	787	807
Capital Goods	5,939	6,728	3,022	3,230	592	523	605
Food and Feed	5,001	5,043	2,344	2,475	421	449	476
Consumer Goods	1,416	1,690	790	1,207	201	249	235
Imports (Customs)	68,783	81,911	39,960	40,628	6,832	6,934	7,333
Automotive Products	24,980	32,849	15,728	16,498	2,736	3,093	2,922
Capital Goods	21,516	25,334	12,332	13,693	2,356	2,188	2,523
Consumer Goods	14,017	15,451	7,644	6,207	1,048	978	1,128
Industrial Supplies	7,035	6,949	3,611	3,639	593	582	656

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1985	1986	January-June 1986	January-June 1987	April 1987	May 1987	June 1987
Discount Rate (end of period)	5.0%	3.0%	3.5%	2.5%	2.5%	2.5%	2.5%
Outstanding Money Supply	8.4%	8.7%	8.7%	9.4%	9.8%	10.2%	10.0%
Industrial Production	4.6%	-0.4%	0.2%	0.8%	0.3%	-0.8%	3.0%
Manufacturing Operating Rate	1.2%	-4.8%	-3.3%	-2.1%	-1.4%	-2.9%	0.1%
Number of Bankruptcies	-9.7%	-7.1%	-7.5%	-23.1%	-29.4%	-32.2%	-30.2%
Residential Construction Starts	4.1%	10.4%	4.0%	18.6%	19.3%	24.7%	28.1%
Job Openings to Applications (ratio)	0.68	0.62	0.64	0.64	0.64	0.65	0.67
Nominal Wages	3.6%	3.5%	4.1%	2.7%	2.1%	2.4%	3.5%
Labor Productivity	4.2%	2.3%	2.7%*	2.1%*	2.3%	n.a.	n.a.
Wholesale Prices	-1.1%	-9.3%	-8.0%	-7.0%	-6.0%	-5.3%	-4.2%
Consumer Prices	2.0%	0.6%	1.2%	-0.4%	0.1%	0.0%	0.3%
Yen-Based Export Prices	-1.4%	-14.5%	-15.3%	-7.1%	-7.7%	-6.5%	-5.1%
Yen-Based Import Prices	-2.5%	-34.7%	-30.0%	-18.4%	-11.6%	-6.3%	-3.2%

*Through April of each year only.

For Japan's most recent GNP figures, see JEI Report No. 24B, June 26, 1987.